Internal Revenue Service

memorandum

CC:TL-N-2103-89
Br4:RBWeinstock

date: MAR 16 1989

to: District Counsel, Nashville
Attn. Paul M. Kohlhoff

from: Assistant Chief Counsel (Tax Litigation)

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subject: [redacted] v. Commissioner,
T.C. Docket No. [redacted]

This responds to your tax litigation advice request which we received on December 21, 1988, and in confirmation of our oral advice to you. We have coordinated you request with the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) (CC:EE). Their views are contained in the enclosed memorandum dated March 16, 1989, in which they agree that we should litigate the taxability of the payments received by taxpayer [redacted] and suggest possible arguments that may be appropriate in litigating this case.

ISSUE

Whether a taxpayer who takes out multiple hospitalization insurance policies may exclude all amounts received under these policies pursuant to I.R.C. § 104(a)(3).

FACTS

During an examination of the petitioner's [redacted] tax years, the Service determined that numerous unexplained bank deposits were made by the taxpayer. The petitioner claimed that such amounts were received from accident or health insurance policies, and thus, excludible under I.R.C. § 104(a)(3). The Service can establish that the taxpayer had in excess of [redacted] insurance policies in each of the years at issue.

The type of policy that the petitioner purchased is referred to as a "guaranteed hospital indemnity policy." This form of insurance is designed to defray the cost of hospitalization not covered by a major medical plan such as [redacted]. Typically, these policies pay a set amount from $[redacted] to $[redacted] per day, for each day of hospitalization. Generally, the application forms for these policies do not inquire as to whether the beneficiary is covered by other insurance because the nature of the coverage is designed to be supplemental to other coverage.

During the years at issue, the taxpayer allegedly suffered falls or other accidents leading to back or other injuries.

While living in Arkansas, he would consult with a doctor in Minnesota who would have him hospitalized for a week or two. He submitted claims on each of the policies he had. On the claim forms, the beneficiary was to provide the company with the names of other insurance companies with with the benficiary had a policy. The taxpayer would list only one other insurance company, typically [redacted]. In addition, the taxpayer used different social security numbers on many of the claim forms, and used different birthdates than those appearing on hospital records.

DISCUSSION

Section 104(a)(3) provides:

> In general, except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include--
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> (3) amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer).

Treas. Reg. § 1.104-1(d) provides that section 104(a)(3) excludes from gross income amounts received through accident or health insurance for personal injuries or sickness. If therefore, an individual purchases a policy of accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under section 104(a)(3).

The exclusion of amounts received through accident or health insurance was originally codified in the Revenue Act of 1918. In its report on the Revenue Bill of 1918, the Committee on Ways and Means Stated:

> The bill (sec. 212) defines net income to mean the gross income defined in section 213 less the deductions allowed by section 214. Gross income will include the same items of income as are included under the present law, with the following exceptions:
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(6) Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provided that such amounts shall not be included in gross income.

H.R.Rep. No. 767 at p. 9, 65th Cong., 2d Sess.

We have not been able to locate any cases which explain the statement in the committee report that amounts received through accident or health insurance were not includible in income prior to the Revenue Act of 1918. However an opinion of the Attorney general (copy enclosed) dated June 26, 1918, stated that the proceeds of an accident policy are excludible because "[t]hey merely take the place of capital in human ability which was destroyed by the accident. They are therefore 'capital' as distinguished from 'income' receipts." 31 Op. Atty. Gen. 304 (1918).

However, there is case authority to support the proposition that damages received on account of personal injury under I.R.C. § 104(a)(2) are excludible because they make the taxpayer "whole". See Starrels v. Commissioner, 304 F.2d 574 (1964), aff'g. 35 T.C. 646 (1961) wherein the Court relied on Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), and stated as follows:

> . . . . Damages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights -- because, in effect they restore a loss to capital.

While the instant case involves I.R.C. § 104(a)(3) rather than I.R.C. § 104(a)(2), we believe that the rationale of the exclusion is the same for both sections, i.e., the amount recovered is to be excluded from income because it makes the taxpayer whole.

In Haynes v. United States, 353 U.S. 81 (1957), which was cited with approval in Jackson v. Commissioner, 28 T.C. 36 (1957), the Supreme Court held that the term "health insurance", under the predecessor of I.R.C. § 104(a)(3) should not be limited to conventional health insurance policies issued by commercial companies and instead gave the term a broad general meaning, i.e., the Court stated that "[b]roadly speaking, health insurance is an undertaking by one person for reasons satisfactory to him to indemnify another for losses caused by illness."

In view of the broad definition of health insurance adopted by the Supreme Court in Haynes v. United States, we think that it would be desirable for respondent on brief to argue that, in substance, petitioner simply devised a scheme to obtain income by purchasing many policies, go to a hospital for several weeks a year, and be reimbursed numerous times for his so-called treatment. Therefore, petitioner was not being reimbursed for "personal injuries or sickness" within the meaning of section 104(a)(3).

Although, it would appear that petitioner has satisfied the literal requirements of section 104(a)(3), we believe that respondent should also argue that Congress never intended that the term "accident or health insurance" should be construed to permit petitioner to exclude the amounts recovered and it is therefore necessary to apply Congressional intent to the specific facts presented. In support of this argument, you may wish to consider the following statement in Keeton, Insurance Law A Guide to Fundamental Principles, Legal Doctrines, and Commercial Practices Practitioner's Edition 4 (1988) (copy of excerpt enclosed):

> When it is essential to decide whether a transaction involves insurance, neither the characterizations of the parties in the contract (that is, whether the parties are explicitly identified as insurer and insured, by some other comparable nomenclature, or by terms that bear no relationship to such designations) nor the fact that one party is committed to do something upon the occurrence of a specified contingency for the other party, will necessarily dictate the resolution of a dispute about the nature of the arrangement at issue. Similarly, recognition that a particular contractual arrangement involves the transfer and distribution of risk generally is not sufficient to answer the question. Although risk transference and risk distribution are among the basic characteristics of almost all insurance transaction, the resolution of a dispute about what constitutes insurance usually is predicated on additional factors or considerations.
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> It is, perhaps, quite natural to anticipate that a definition of insurance would be provided at the beginning of a text on insurance law. There are several reasons, in addition to the problems described in the preceding paragraphs, for not setting forth a definition in this section. First, the question "What is insurance?" arises in many different contexts. Not only are the purposes for which definitions of insurance are sought diverse, but the socio-economic

> and other factors that influence the definition often differ substantially from one situation to the next. Consequently, the appropriateness of a particular characterization usually depends on the reason why a definition is needed. For example, the definition of insurance that is either explicit or implicit for purposes of the statutes regulating entities engaged in an insurance business may be quite different from the definition of insurance used in an estate tax law concerned with determining whether it is appropriate to tax payments made to a beneficiary.
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> There is no single conception of insurance that is universally applicable for use in disputes involving questions of law. Furthermore, in a particular jurisdiction the applicable definition of insurance may also be significantly influenced by legislative actions and, in some instances, prior judicial decisions. Accordingly, in the process of selecting or framing an appropriate response to a definitional question, an essential first step for a lawyer is to ascertain both the reasons why the issue arises and the legislative provisions or judicial precedents which may be relevant to the resolution of the question.

In providing for an exclusion for certain payments from accident and health insurance, Congress did not intend to exclude the amounts the taxpayer is attempting to exclude. As a matter of statutory construction, exemptions and deductions from taxation are strictly construed. Helvering v. Northwest Steel Rolling Mills, 311 U.S. 46, 49 (1940) (restating principle of construction); Commissioner v. Jacobson, 336 U.S. 28, 49 (1949) (gift tax exclusion); Silverman v. Commissioner, 28 T.C. 1061, 1067-1068 (1957), aff'd., 253 F.2d 849 (8th Cir. 1958) (gift tax exclusion strictly construed). See generally 1 Mertens Law of Fed Income Tax §§ 3.07-3.08 (1988) and 3A Sutherland Stat Const. § 66.09 (4th Ed. 1986).

Along these lines we note that even if the payments literally fall within the section 104(a)(3) exclusion, there is case law sustaining the Service's denial of certain deductions claimed by taxpayers although the taxpayers satisfied the literal Code requirements. For example, in Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g. 44 T.C. 284 (1965), cert. denied, 385 U.S. 1005 (1967), the Court of Appeals for the Second Circuit affirmed the Tax Court's decision which disallowed the taxpayers' interest deduction under I.R.C. § 163(a) for prepaid interest where the underlying loan transaction had been entered into for the purposes of the anticipated tax consequences, and without any realistic expectation of economic profit, even though the transaction satisfied the literal requirements of I.R.C.

§ 163(a) which simply provides that "[t]here shall be allowed as a deduction all interest paid or accrued within a taxable year on indebtedness."

In holding for the Government, the Second Circuit stated:

> In order fully to implement this Congressional policy of encouraging purposive activity to be financed through borrowing, Section 163(a) should be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way.

364 F.2d at 741.

It is clear from Judge Fay's dissent in Goldstein v. Commissioner, 44 T.C. at 305 ("To hold for respondent [would] engraft upon section 163 a qualification and penalty unwarranted by the literal language and intendment of the provision"), that the Courts did not follow the literal language of I.R.C. § 163(a). Instead, the Second Circuit fashioned a test based upon Congressional purpose. Similarly in the instant case, we believe that it is beyond cavil that Congress never intended that the amounts petitioner received should be excluded as payments for "accident or health insurance" because petitioner did not merely intend to make himself "whole" by restoring lost capital. Instead, petitioner's purpose in buying numerous policies was to make a profit.

We believe that Rev. Rul. 69-154, 1969-1 C.B. 46, which the taxpayer relies on, is distinguishable from the facts in this case. In Rev. Rul. 69-154, a taxpayer paid premiums of $240 and $120 for two personal health insurance policies. During the year the taxpayer had only one illness, and incurred and paid total medical expenses of $900. In the same year, the taxpayer was indemnified $700 and $500 under the respective insurance policies. The ruling held that the $300 excess indemnification is not includible in gross income. The excess indemnification that Rev. Rul. 69-154 held was excludable is properly viewed as a de minimis amount. Furthermore, the purchase of two health insurance policies which enabled a taxpayer to be made whole is distinguishable from the egregious facts of the instant case where taxpayer purchased many insurance policies with an intent to make a substantial profit, and not with an intent to make oneself whole.

An additional argument to be raised with the Tax Court is that allowing the petitioner to exclude under I.R.C. § 104(a)(3)

the amounts received would frustrate public policy. The public policy doctrine, which has been applied to disallow various types of deductions, provides that an otherwise permissible deduction will be disallowed where its allowance would frustrate a well-defined public policy. See Blackman v. Commissioner, 88 T.C.677 (1987); Note, The Judicial Public Policy Doctrine in Tax Litigation, 74 Mich. L. Rev. 131 (1975). The aim of the doctrine is to avoid a conflict between tax laws and other substantive policy. Note supra., 74 Mich. L. Rev. at 140.

In Commissioner v. Tellier, 383 U.S. 687 (1966) the Supreme Court outlined a test to determine whether a deduction would violate the public policy doctrine. In applying the test, the courts must examine (1) whether the allowance of the deduction would frustrate a sharply defined national or state policy proscribing types of conduct (Commissioner v. Heininger, 320 U.S. 462, 473 (1943)); (2) whether there is some governmental declaration of that policy (Lilly v. Commissioner, 343 U.S. 90, 97 (1952)); and (3) whether the frustration resulting from the allowance of the deduction would be severe and immediate (Tank Truck Rentals v. Commissioner, 356 U.S. 30, 35 (1958)).

While many of the cases involving the public policy doctrine have involved whether a taxpayer is entitled to a deduction, public policy has been used to deny racially discriminatory schools tax-exemption, Bob Jones University v. United States, 461 U.S. 574 (1983), and the doctrine would appear to be applicable to exclusions from income as well as deductions and exemptions.

The applicability of the public policy doctrine turns on the particular facts of a given case. Blackman v. Commissioner, 88 T.C. at 680. On claim forms, the taxpayer would generally provide the name of [redacted] as another insurance company with whom he had a policy, and he did not provide the names of the many other insurance companies with whom he had a policy. He also used different social security numbers on many claim forms, and listed different birthdates than those listed on the medical records provided to your office by the various hospitals to which he was admitted. Taxpayer's conduct, in filling out and mailing the claim forms with incomplete and false information, may have constituted a criminal act of mail fraud within the meaning of 18 U.S.C. § 1341. Furthermore, it may have been a violation of 42 U.S.C. § 408(g)(2) which makes it a crime to use a false social security number for the purpose of obtaining a payment or benefit to which the person is not entitled. Such acts might also constitute theft of property by deception under Arkansas law. Ark. Stat. Ann. §§ 5-36-101(3) and 5-36-103 (1987). There may have also been other improper acts by the taxpayer that respondent can rely upon.

Insofar as petitioner's actions arguably violated various federal and state criminal statutes, allowance of the section 104(a)(3) exclusion would severely frustrate the strong public policies reflected by these statutes. It is not necessary to show that the taxpayer was arrested or even formally charged with a crime, in order to argue that public policy was violated by actions violating a criminal statute. Blackman v. Commissioner, 88 T.C. at 680-81. We have attached a copy of the Department of Justice's appellate brief in Sammons v. Commissioner, 838 F.2d 330 (9th Cir. 1988), aff'g. T.C. Memo. 1986-318, in which a public policy argument was made. While the Government did not prevail on the public policy argument, the analysis in the brief should be helpful in briefing this point.

You may also wish to argue that the proceeds from the insurance policies were analogous to embezzlement income. In Frempong-Atuahene v. Commissioner, T.C. Memo. 1989-67 (copy enclosed), the Tax Court held that welfare payments received by the taxpayers were not excludable because the petitioners made false representations to gain benefits to which they were not entitled. Similarly, it can be argued that the section 104(a)(3) exclusion would be inapplicable to payments the taxpayer received through false representations, because such payments were analogous to embezzlement income.

CONCLUSION

The petitioner may not exclude from gross income under I.R.C. § 104(a)(3) the amounts he received from the multiple hospitalization insurance policies that he took out. If you require any further assistance on this matter, please do not hesitate to call Ronald Weinstock at FTS 566-3345.

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Enclosures:
Memorandum from CC:EE dated March 16, 1989
T.C. Memo. 1989-67
31 Op. Atty. Gen. 304 (1918)
Sammons v. Commissioner brief
Excerpt from Keeton's Insurance Law